'81-SBE-063'

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MAURICE F. AND MARY D. CORREIA)

Appearances:

For Appellants: Henry W. Blue
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the actions of the Franchise Tax Board on the protests of Maurice F. and Mary D. Correia against proposed assessments of additional personal income tax in the amounts of $6,416.12 and $20,977.00 for the year 1974.

During 1974, appellants sold their interest in Ocean Fisheries, Inc., realizing a capital gain of $655,030. Their other reportable gross income for that year was approximately $75,000. In 1971, their gross income had been reported as approximately $75,000, and in both 1972 and 1973, approximately $95,000.

In December 1974, appellants purchased a shopping center for $815,000. They made a cash down payment of $165,000 and gave the seller a note for $650,000 which was secured by a trust deed on the shopping center. The escrow instructions for the transaction provided that the interest which would accrue during 1975, amounting to $58,324, should be deposited in the escrow and prepaid at close of escrow. The escrow closing statement, dated December 31, 1974, showed that the prepayment was in fact made. Interest for other years was not to be prepaid.

Appellants also entered into a cattle-raising arrangement in December 1974, with the 3-D Cattle Company, Inc. ("3-D"); Appellants were to finance the purchase and costs of raising a number'of beef calves, which were to be sold the following summer with appellants receiving the proceeds. The cattle were purchased on December 10, 1974. 3-D was to be responsible for the actual raising and selling of the cattle, charging appellants yardage as well as other raising costs such as food, medicine, and delivery costs. This arrangement was financed in part by a $200,000 line of credit which appellants obtained from the Bank of America ("the bank"). The credit line was to remain open until December 1, 1975, with interest, at 1 1/4% over the bank's prime lending rate, payable monthly. Appellants signed a demand note dated December 5, 1974, which. provided for the monthly interest payments to begin January 1, 1975. The bank allowed appellants to prepay up to $10,000 of the interest which would accrue in 1975. This was apparently done at appellants' request, the bank's manager stating in a letter dated December 20, 1974 that the bank would "need to post this prepayment by December 31 to give [appellants] the tax advantage . . . . ." On December 30, 1974, appellants' prepayment of $10,000 of interest was entered on the bank's loan ledger.

On December 20, 1974, 3-D received a draft from the bank in the amount of $180,700, which was

charged against appellants' line of credit.- This was to pay for 1,300 tons of feed apparently bought from 3-D. None of this feed was consumed in 1974 and approximately five percent of it remained unused at the time the cattle were sold in 1975.

On their California personal income tax return for 1974, appellants, as cash basis taxpayers., claimed deductions for the two interest prepayments of $58,324 and $10,000 and for the $180,700 cost of the cattle feed. Respondent examined the return, reallocated the shopping center interest prepayment to 1975, and issued a proposed assessment of $6,416.12 for 1974. Appellants protested this assessment. Respondent, after a reexamination of the return, denied'the protest, and issued another assessment for $20,977 reflecting the reallocation of the cattle-feed expenses and line-of-credit interest to 1975. The protest on the second assessment was also denied, resulting in the present appeal.

The issue presented as to both assessments is whether appellants are entitled to deduct in 1974 certain expenses prepaid in that year. Appellants take the position that, as cash basis taxpayers, they are entitled to take deductions for interest and business expenses in the year paid, i.e. 1974.

Respondent, however, contends that allowing these prepayments to be deducted in 1974 would materially distort appellants' income for that 'year. It maintains that the deductions were properly reallocated to 1975, when the interest liability was actually incurred and the feed was consumed, pursuant to its authority under Revenue and Taxation Code section 17561(b). Additionally, respondent asserts'that the interest expenditures have not been shown to be deductible payments rather than mere refundable deposits, which are not deductible.

As a general rule, a deduction is properly taken in the "taxable year which is the proper taxable year under the method of accounting used in computing taxable income." (Rev. & Tax. Code, § 17591, subd. (a).), Taxable income is to be computed "under the method of accounting on the basis of which. the taxpayer regularly computes his income in keeping his books." (Rev. & Tax. Code § 17561, subd. (a):) .-The regulation accompanying section 17591 states:

> Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. (Cal. Admin. Code, tit. 18, reg. 17591, subd. (a)(l).)

Our inquiry then is directed to whether appellants' expenditures fall within these general rules or are to be treated differently under some exception to the general rules.

The Prepaid Interest[1/]

Revenue and Taxation Code section 17203(a) allows deductions for "all interest paid or accrued within the taxable year on indebtedness." Basic to a finding of deductibility in the case of a cash basis taxpayer, is the requirement that the interest be paid in the taxable year. If unearned prepaid interest is refundable, the expenditure is considered a deposit rather than a payment, and therefore not deductible until the period to which it applies. (S. Rex Lewis, 65 T.C. 625, 630 (1975); Andrew A. Sandor, 62 T.C. 469, 482-483 (1974), affd. 536 F.2d 874 (9th Cir. 1976).)

It is well settled that respondent's determination is presumed correct, and the burden is on the taxpayer to show that it is erroneous. (Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 414] (1949).) Moreover, deductions are a matter of legislative grace, and the taxpayer bears the burden of showing his right thereto. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of William W. and Marjorie L. Beacom, Cal. St. Bd. of Equal., Oct. 6, 1976.) Appellants have never addressed the issue of payment versus deposit, either in their reply brief or at oral hearing. However, after close examination of what is admittedly a deficient record, we believe that

1/ Revenue and Taxation Code section 17595 now requires cash method taxpayers in most instances to deduct prepaid interest over the period of the loan. However, this section only applies to amounts paid in taxable years beginning after December 31, 1976, so it is not determinative of the issue for the year before us in this appeal.

the payments here might well be characterized as deposits.

This is most evident with the line of credit which was granted appellants by the bank. A line of credit differs from an ordinary loan in that, although there is a maximum amount of principal which may be outstanding at any time, there is no lump sum given to the debtor when he signs the promissory note. Over the time during which the line of credit remains open, the debtor may actually use only a small amount of the credit available to him or, by making occasional principal payments so that the maximum amount is never exceeded at any one time, borrow a total amount 'which is several times more than the maximum. 'Because there are varying amounts borrowed for varying periods of time, it is impossible to know, until the 'line of credit is terminated, how much, if any, interest is payable. This uncertainty is exacerbated in this case because the interest rate itself varied in accordance with the bank's prime lending rate. On December 30, 1974, neither appellants nor the bank could have known how much, if indeed any, of the amount prepaid would become payable.[2/] We find it extremely difficult to describe an expenditure made in anticipation of money being loaned in the future as "interest paid" as that term is used in Revenue and Taxation Code section 17203.

Additionally, we note that prepayment of principal was not only allowed, but required. The terms of the line of credit include a provision that "[a]ll proceeds of cattle sales are to be applied directly to [appellants'] indebtedness . ..." With no evidence to the contrary, we must assume that any unearned interest. resulting from such prepayments of principal would be

2/ Although it appears that the line of credit was. drawn upon in 1974, appellants have not shown the amount of interest which may have been attributable to any amount borrowed in that year, so we must assume that the entire amount prepaid was attributable to interest for 1975.

refunded to appellants. In light of all these factors, the $10,000 paid by appellants to the bank on December 30, 1974, could not be anything other than a deposit. Respondent's allocation of the payment to the year when the money was actually loaned and the interest liability actually incurred, is quite clearly proper.

A close review of the record in regard to the shopping center interest provides us with no useful information on this issue. Appellants have not provided us with the slightest information regarding the terms of the note, and this failure on their part must bear heavily against them. (Appeal of Janice Rule, Cal. St. Bd. of Equal., Oct. 6, 1976.) Although appellants apparently feel that they need- not respond to any issues not specifically raised in the notices 'of proposed assessment, we have not been shown by them, nor have we encountered otherwise, any authority to that effect. We can see no possible unfairness to appellants in this, since not only did respondent clearly state this issue as an alternative argument in its brief, but it is also often a fundamental inquiry in the tax court cases in this area. (See,'e.g., S. Rex Lewis, supra; Andrew A. Sandor, supra.)

We find that appellants have failed to show that either of the "interest prepayments" made in 1974 were not simply deposits to be applied to interest to be incurred in the future and subject to refund upon prepayment of the principal. Having so found, we need not consider whether the prepayments caused a material distortion of income. Respondent's action in disallowing the deductions in 1974 and allocating them to 1975 must therefore be.sustained.

The Prepaid Cattle-Feed Expense?/

The allowance of a deduction for this $180,700 expenditure in 1974, respondent contends, would materially

3/ Revenue and Taxation Code section 17599.1, operative for taxable years beginning in 1977 and thereafter, limits feed expense deductions of "farming syndicates** to the taxable year when consumed. Despite respondent's suggestion to the contrary, we do not believe that this section has any applicability to the year before us or to individual taxpayers in general. (See Kenneth H. Van Raden, 71 T.C. 1083, 1106 (1979).)

distort appellants' income. The timing of the expenditure, its relation to appellants' income, and the lack of a demonstrated business purpose for the expenditure are the reasons given for respondent's position. Appellants assert that they have shown a business purpose for the prepayment since the maximum price was thereby fixed and a guaranteed supply obtained.

The parties have 'structured their arguments around the criteria for deductibility'of prepaid feed expenses set forth in Revenue Ruling 75-152, 1975-1 Cumulative Bulletin 144.[4/] Clearly, revenue rulings do not have the' force and effect of Treasury Department regulations, and they are not binding on the courts. (Andrew A. Sandor, supra, 62 T.C. at 481-482.) However, some courts have analyzed this issue in the context of this ruling (see,, e.g., Kenneth H. Van Raden, 71 T.C. 1083 (1979), app. pending 9th Cir.; Clement v. United States,, 580 F.2d 422 (Ct. Cl. 1978); Dunn v. United States, 468 F.Supp. 991 (S.D.N.Y. 1979)) and the parties here have done so as well;' We therefore find .it appropriate to use Revenue Ruling 75-152 as a guide for our analysis.

This ruling imposes. three conditions 'for the deductibility of prepaid feed expenses:' (1) the expenditure must be- for the purchase of feed rather than a deposit, (2) the prepayment must be made for a business purpose and not merely for tax avoidance, and (3) the deduction must not result in a material distortion of income. Neither party having raised the question of whether the expenditure was a deposit, we do not consider that issue in this appeal.

The second criterion; that the prepayment must have a business purpose and not be merely for tax avoidance, is contested by the parties. Generally, the ruling states, the cases which have allowed such

4/ Revenue Ruling 75-152 has been superseded by Revenue Ruling 79-229, 1979-2 Cumulative Bulletin 210. However;. since the parties have not referred to this new ruling and it merely restates and amplifies the'previous ruling, we refer here only to Revenue Ruling 75-152.

deductions have found that the taxpayers acquired, or had a reasonable expectation of acquiring, some business benefit from the prepayment of expenses. The revenue ruling provides some examples of business benefit, such as the fixing of maximum prices,, securing an assured supply of feed, or securing preferential treatment in anticipation of a feed shortage. Consideration is also given to whether the prepayment was a condition imposed by the seller and whether such condition was meaningful. Since a business purpose clearly exists for the purchase of feed by a livestock raiser, the business purpose test of the revenue ruling must be directed to the timing of the expenditure. Although we question the propriety of such a test for timing, it is unnecessary for us to address the issue, since we find the business purpose requirement of the ruling to be met in this appeal. 5/

Appellants state that their prepayment fixed the maximum price for the feed and guaranteed the supply. They also submitted a statement of Mr. Fairbank, who is identified as the person who purchased the cattle and feed on behalf of the appellants. Mr. Fairbank stated that feed prices had been going up in the fall of 1974 and he advised appellants to purchase feed in the fall before prices increased further. Unfortunately, he said, feed prices declined in January 1975 and continued to decline throughout that year. He also indicated that the prepayment helped to guarantee the feed supply for appellants' cattle, that his practice was to purchase feed in the fall for use the following year if market conditions indicated that prices would increase, and that he knew prepayment for feed was a common practice in the locale of the feed lot. Given this uncontested evidence, we believe that appellants have shown they had a reasonable expectation of receiving some business benefit as a result of the timing

5/ See the discussion of this matter and relevant citations in the Appeal of Verne D. and Joanne 0. Freeman, decided this day.

of the prepayment. We also believe that tax avoidance was a motive; but cannot say that the prepayment was made merely for tax avoidance. Therefore, the second test of the revenue ruling is satisfied.

The third criterion in Revenue Ruling 75-152 is that the deduction must not result in a material distortion of income. The material distortion of income test is based on section 446(b) of the Internal Revenue Code of 1954 and its predecessors in previous federal revenue acts. Revenue and Taxation Code section 17561(b) is virtually identical to Internal Revenue Code section 446(b). Therefore, federal case law is highly persuasive in determining the correct interpretation of the California section. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428] (1941); Meanly v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942).)

Section 17561(b) provides:

> If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Franchise Tax Board, does clearly reflect income.

This section allows respondent broad discretion to modify a taxpayer's method of accounting to ensure a clear reflection of income, and respondent's determination will not be interfered with absent a showing of abuse of that discretion. (Clement v. United States, supra, 580 F.2d at 430.)

Respondent makes essentially the same argument in this case that it made with regard to a prepaid cattlefeed expense in the Appeal of Verne D. and Joanne O. Freeman, decided this day. The argument is that the timing and large amount of the prepayment result in a material distortion of income and it is within respondent's discretion, therefore, to reallocate the expense deduction pursuant to section 17561(b).

We rejected respondent's argument in the Freeman appeal and must do so in this case as well. In Freeman we were persuaded by the reasoning of the tax court in the case of Kenneth H. Van Raden, supra, which held that where a livestock raiser consistently uses the cash method of accounting, a substantial legitimate business purpose will satisfy the material distortion of income test. This conclusion is based on the several statute's and regulations which accord special treatment to farmers, specifically allowing them to use the cash method of accounting.

We find this analysis to be controlling in this case. Appellants have consistently used the cash method of accounting and we conclude that they have shown a sufficiently substantial, and legitimate business purpose for the prepayment to satisfy the material distortion of income test as enunciated in Van Raden. Therefore, we find that respondent has abused its discretion in applying subdivision (b) of section 17561 in this case.

For the reasons discussed above, respondent's action in regard to the cattle-feed expense deduction must be reversed.

Appeal of Maurice F. and Mary D. Correia

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section, 18595 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board on the protests of Maurice F. and Mary D. Correia against proposed assessments of additional personal income tax in the amounts of $6,416.12 and $20,977.00 for the year 1974, are hereby modified to reflect the allowance of the prepaid cattle-feed expense deduction. In all other respects the actions of the Franchise Tax Board are sustained.

Done at Sacramento, California, this 23rd day of June, 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Reilly, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr., Chairman

George R. Reilly, Member

William M. Bennett, Member

Richard Nevins, Member

, Member